BRITAIN & OVERSEAS

A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

Summer 1996 Vol. 26, No. 2

Editor: Jim Bourlet

Published quarterly by

The Economic Research Council

239 Shaftesbury Avenue, London WC2H 8PJ

Price: U.K. £12 Australia $25 Canada $25 New Zealand $35 U.S.A. $25 Japan ¥4,000

President	Lord Ezra
Chairman	Damon de Laszlo

Vice-Presidents

Rt. Hon. John Biffen MP	Sir Peter Parker MVO
Lord Killearn	Brian Reading

Hon. Secretary	James Bourlet
Executive Secretary	Professor Peter Davison

MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. The minimum annual subscription for individual members is £25 for full members, £15 for Associate members, and Student members £10.

Corporate membership is open to all companies and other bodies, minimum annual subscription £55 (Educational institutions £40) in respect of which they may send up to six nominees to any of the Council's discussion meetings and lectures.

Executive Committee

Damon de Laszlo (Chairman)	Tudor Gates
A. Baron	P.L. Griffiths
James Bourlet	J. Hatherley
M.H.Cadman	R. McGarvey
E.A. Clark	Mrs D. Jenkins McKenzie
Peter Davison	A. B. Parker

ECONOMISTS AND ECONOMIC HISTORIANS NEED TO WORK TOGETHER AGAIN

A talk by Theo Barker, Professor Emeritus of Economic History in the University of London and President of the International Historical Congress 1990–1995, to members of the Economic Research Council on Monday 25th March 1996

Economics and economic history are no longer the popular subjects they used to be. University economists speak with so many different voices and seem to the general public to have become remote, theoretical and mathematical – remote from everyday life and its problems. When economic views are sought by radio and television, it is more often than not the opinions of economic advisers to the banks or other City institutions that are sought, not those of university professors of economics. Economic history is in equal trouble, though it remains strong in London, Oxford and Cambridge (where circumstances have not changed) and at Manchester where it has always been, and remains, a strong sub-section of history. Looking at the kingdom as a whole, however, there are depressing signs. In provincial universities whole departments are being closed and those that have not been closed are threatened with closure. Many economic historians are taking early retirement. Others are moving elsewhere in their universities, mainly to history departments where they will be in a small minority. Since recruitment over the past decades has been small and the survivors are ageing and soon to retire, will they be replaced by other economic historians? The l990s are very different from the 1950s and 1960s when U.K. membership of the national Economic History Society, publishers of the *Economic History Review*, grew by 10 per cent a year. In the 1970s it stagnated. Then it slowly declined.

I arrived at the London School of Economics in 1953 when the prosperous years were starting. I had taken my first degree, in history, at Oxford and begun to turn myself into an economic historian by concentrating upon the economic history aspects of the subject. I continued the process by taking a Ph.D. in Manchester with a thesis about the growth of a northern industrial town in the nineteenth century. After that I started to write the history of Pilkington, the family glass business and took a research fellowship in the department of political economy at Aberdeen with Henry Hamilton and an engaging team of young economists: Fraser Noble, Denys Munby and Roy Campbell. From there I arrived at LSE, being paid the princely salary of £450 a year as an assistant lecturer.

There were also a number of economists to talk to in the Common Room – and a relatively leisurely life which allowed one to go there for coffee in the morning and tea in the afternoon, as well as to lunch. We chatted to fellow economic historians, of course, whom we usually met up there rather than in the department itself, for in those days our rooms were scattered around various parts of the East Wing. Among the economists were men like Henry Phelps Brown, who wrote a book about British industrial relations between 1906 and 1914 and articles about long-run wage and price trends from the Middle Ages onwards with Sheila Hopkins (Mrs Leslie Pressnell), another economist who later joined the LSE staff and subsequently became a professor of economic history. Professor Phelps-Brown was remarkable from infancy, though I did not realise what a prodigy he had been until I wrote, with the Pressnells' help, his obituary for *The Times*. Then there was Richard Sayers, who wrote on monetary history and banking and later became President of the Economic History Society. Lionel Robbins himself, an imposing figure in the Common Room, was interested in the history of monetary policy and in the past generally. Basil Yamey still very much around at LSE though long retired, was the authority on the history of accounting. And my own professor, T. S. Ashton, who arrived at LSE in 1944 and became world famous thanks to his little gem of a book on the Industrial Revolution, had been previously reader in currency and finance at Manchester and wrote while there a centenary history of the Manchester Statistical Society and the life of Peter Stubs, the Warrington file maker, from tea chests of Stubs' business records in the economics department

Where are the economists who talk the same language as economic historians these days? They are few and far between. I have already mentioned Leslie and Sheila Pressnell who write about the financial history of the Second War and after. And Sir Alec Cairncross at Oxford, who immediately springs to mind because of his uniqueness. But today it is a different academic world.

There seems to me to be a case for economists to get together first of all to look at what is being taught in the schools. I suppose that we have to assume that interesting younger children in the past depends upon the ability of gifted teachers to stir their imaginations, for at that age children are too involved in coming to grips with the world they are growing up in to have much time for years gone by. 1986 might as well be 1066 to a child growing up in 1996. Gifted teachers can only hope to arouse interest by telling stories to the under tens. After that the past is seen as a series of heroes and villains, triumphs and disasters. When it comes to putting these in some sort of date order, the whole thing becomes a kind of memory test. History becomes not only irrelevant but also hateful, especially to those without reasonably good memories. There is much more in the world – and at school – that is much more interesting and (blessed word) 'relevant'. Most children drop history as soon as they can, usually by about age 14. The interesting thing is that many of them come back to it later in life when they get interested in the history of their families. It is a fact that the main users of local record offices – and even of the Public Record Office are not professional historians or members of the legal or any other profession, but ordinary folk trying to find out more about their ancestors. Here, perhaps, we ought to find a means of stimulating children's interest in the past at the age of 14 or thereabouts. What is now grandly called Oral History has given rise, over the past 30 years or so, to many interviews with older people who, of course, can also pass on what their own parents, grandparents and other relatives told them about their earlier lives and times. Sometimes this is now available on videotape as well as just sound. Teachers dealing with the past 100 years or more can play short extracts of people telling exactly what it was like to live then or what their own parents or grandparents had told them. This could relate not only to family matters but also to how these people saw the great names and events of the past which children now find so dry as dust and 'irrelevant'. This should go some way to reducing the haemorrhage from history at 14 or before.

So we come to the upper forms at school. This is where economists and economic historians need to be getting together to influence the new national syllabuses. History courses are still far too influenced by the approach which was so cleverly lampooned in *1066 and All That*. Surely it ought to be possible to emphasize in all teaching, and in the text books, that economic growth greatly improves the wellbeing of people all over the world and that the pace of growth, evident enough in earlier times, has been accelerating since the eighteenth century if not before. Not uninterruptedly, of course. There have been epidemics, disasters of various sorts, and wars. Nor have the fruits of economic growth been spread evenly among the people, perhaps especially among populations where growth has been most evident. Yet there never was economic equality, least of all in earlier times. But economic growth brings greater equality of opportunity. The poor become less poor and the whole definition of poverty changes. Here is a view of the past which inevitably gives rise to debate and discussion among older schoolchildren as they come to form their own, or come to agree or disagree with their parent's political outlook on life. This is an approach which can be made internationally to past events especially by students of British history for Britain was so dependent on European, and then world, trade. And trade led to colonization. And colonization involved investment of capital. And that involved financial risk which, when successful led to further economic growth in those colonies abroad.

Having considered the connection between economic growth and social improvement more generally and looked, perhaps, at what happened in North America and in India and the East in the seventeenth and eighteenth centuries – the latter is most important because the future is clearly nowadays in the Pacific, not in the Atlantic, bearing in mind that the United States has a stake in both – there is a strong case for focusing particularly on the effects of the great opening up of world trade in and after the early 1870s. Cheaper food and raw materials between 1873 and 1896 thanks to the opening up of other climatic areas and cheaper transport (railways in these other continents and the spread of steamships greatly reducing the cost of bulk sea transport), cut the cost of living in the industrialized countries. Earnings there were reduced too, but not to anything like the same amount and, unlike recent inflationary times, earnings fell after prices. The rise in real earnings greatly increased, especially of the poorest people since it was food and non-alcoholic drink (on which 60 per cent of British working class income was spent even in 1913) which fell most. Distribution costs fell, too, as Sainsburys and other multiples spread and there were more Co-ops. There was greater leisure. Saturday half-holidays (and half-holidays on another day of the week for shopkeepers) became general. Sporting fixtures spread. Railway excursions proliferated. Music halls spread as a working class entertainment (often called – significantly – Empires). The Britain of 1896 was different from the Britain of 1873. The poverty exposed by Booth in London at the end of the 1880s and Rowntree in York in 1900 was real enough and shocking to the better-off; but it was poverty of a less cruel kind, and charity, largely aroused by the greater public concern, was more widespread. Local government was developing, too, with more municipal services from which all benefited. ('Gas and water socialism'.) It is true that after 1896 demand from the industrial countries caught up with supply from primary producing areas. Prices rose a little but larger disposable incomes remained. Sports clubs, music halls, cheap excursions and the advantages of 1873-96 all survived and the years before the First War saw the beginnings of state pensions, sickness and unemployment insurance.

Here is a period of history where economists and economic historians can lay the foundations of an understanding of the modern world. One would, of course, talk about the extent to which people in primary producing areas benefited or suffered from the advantages their efforts gave to the more advanced countries, thus stimulating political discussion again, with some students no doubt referring to the evils of 'capitalism' while others would draw attention to the advantages which accrue from successful financial investment.

Another broad theme accompanying all this is the great progress made in research and technology from the mid-nineteenth century, also made possible to a large extent by economic growth which provided the necessary finance and facilities. The books at the moment say little or nothing, for instance, about the dawn of modern medicine. The work of Louis Pasteur in France in the 1850s and 1860s on micro-organisms in the wine industry and brewing which helped Joseph Lister to develop antiseptic surgery and the more general identification of particular germs. Alexander Fleming's discovery of penicillin in the 1930s took the whole process much farther forward with the spread of antibiotics and what present-day doctors would say represented the real beginnings of modern medicine. Remarkable surgical operations are now possible and, indeed, routine. Students should see this in its historical context and come to realise how hospitals have become quite different – and more expensive though affordable – only because of economic growth. Beveridge's career – from the beginnings of social insurance to the Beveridge Report and the beginnings of the welfare state after the Second War, need to be seen in this light.

Other technical developments since the later nineteenth century, which everyone takes for granted nowadays, need to be seen as an essential part of recent history: electricity for lighting and traction; its stimulating competitive effect on the gas industry and the arrival of natural gas; the internal combustion engine and the benefits of public and private road transport; the spread of the cinema from the mid-1890s ('talkies' from the late 1920s); and television launched on a small scale in London, some years before anywhere in the USA, because the government wanted to develop cathode ray tube production for radiolocation (radar).

All these advantages have created offsetting disadvantages, though up to now the former have been much greater than the latter. The internal combustion engine, for instance, which has given so many people greater mobility and cheapened the cost of getting about, has damaged the environment with noise and atmospheric pollution. Technological development has made it possible to wage wars which killed and maimed more and more people, civilians as well as combatants; but the families involved have so far managed to recover from all their loss and grief and to emerge into a world which soon became more prosperous than ever. But can we continue to be sure that this will continue to be true when smaller and less responsible nations get control of nuclear weapons and more modern means of delivering them? Fortunately prediction is not the task of the historian. The experiences of the past, however, are; and they do not inspire confidence.

The past consists primarily of people set against a background of changing conditions. Historians are primarily interested in people. Economists are more interested in the changing conditions under which they lived and the factors influencing those conditions. Take, for instance, unemployment, always an issue of concern, especially to wage earners and more recently to salary earners, too. Before 1939 cyclical unemployment had always been expected in peacetime. In the 1930s Maynard Keynes – a name, like that of Beveridge, that should feature in all history text books – showed how the effects of cyclical unemployment could be reduced by state stimulation of demand instead of the reverse. Monetarists have subsequently had different ideas – and Keynes himself probably would have modified his views to suit the changing times if he had been spared to live beyond his early 60s into the postwar world. Fifty years after his death he is still seen as a towering intellect, keen to make the world a more civilised and less anxious place in which to live.

We are now confronted by an unemployment challenge of a different order of magnitude. Capital, having been invested in factories over the years to reduce the amount of labour needed per unit of output, is now being invested massively in offices which have grown with the increasing size and complexity of manufacturing and other sorts of business. Computers are replacing white collar workers nowadays just as machines replaced blue collar workers in factories and workshops previously, and continue to do. The help of economists is needed even more urgently than in the days of Keynes. And so, I would argue, is the perspective of historians. The two still need each other.

MANIAS, PANICS AND CRASHES
A HISTORY OF FINANCIAL CRISES

By Charles P. Kindleberger
First published 1978; Second Edition by MacMillan 1989 (paperback)

As Wall Street share prices reach unprecedented heights, and react nervously to any hint of increased interest rates, perhaps this is an appropriate moment to review a book which dissects the cycle of financial “bubble” and corrective “bursting”. Time will tell if we are, in fact, witnessing such a cycle in New York stocks.

The first chapter of this splendid book is entitled “Financial Crisis: A Hardy Perennial”. Manias have involved Dutch tulip bulbs, canals, railways, new share issues, farmland and commercial real estate, and a host of others. The work concludes with a copious Appendix listing crises from 1720 to 1987. Professor Kindleberger runs through these episodes in fine style, drawing on contemporary accounts whilst adding dry humorous observations for emphasis. In each case, "hot" (easy) money has chased prices up to inflated, over-optimistic levels until briefly there has been a period of great unease and disturbing rumours of problems, usually an insolvency. Then suddenly, the bubble bursts and there is a flight back to cash, a liquidity crisis when everyone wishes to sell but there are no buyers. The Second Edition has an updated passage on the Wall Street Crash of October 1987, which in the author's opinion was handled "beautifully" by the Federal Reserve System. Certainly, the markets subsequently recovered sufficiently for the price falls to be seen in retrospect as a (healthy) correction, rather than the beginning of a protracted period of misery such as the 1930s.

A recurrent theme of the work, is the fact that the "victims" of crashes so often sense their mistakenness, yet determinedly press ahead like the *Titanic* towards the iceberg. Perhaps Professor Kindleberger's reference to an "infection" is indeed the most appropriate term for this starkly irrational behaviour. Sadly there seems to be no cure for the ailment; each generation has its mania and the subsequent painful collapse. As the peak is reached, various theories are advanced to justify ever higher prices, and to explain (for the benefit of the unsophisticated) that this time, things are different. Take Isaac Newton, then Master of the Mint, who in the spring of 1720 stated: "I can calculate the motions of the heavenly bodies, but not the madness of people". He proceeded to realise a profit of £7,000, a gain of 100 percent, on selling his shares in the South Sea Company. Professor Kindleberger continues: "Unhappily, a further impulse later seized him, an infection from the mania gripping the world that spring and summer. He re-entered the market at the top for a larger amount and ended up losing £20,000."

Throughout this examination, Professor Kindleberger has examples of wise men and fools, who have been soon parted from their money. Manias have erupted and collapsed, but behaviour patterns remain fairly constant. "Emerging markets" are regular crazes, going back at least to medieval times, with distance and mystery adding to, rather than detracting from, the perceived attractions of a speculation. Our author clearly sees no prospect of the prevention of these outbreaks, and he considers them in the light of the Efficient Market. Economists (notably Minsky) have created models of this boom-and-bust cycle, whilst Friedman has held that "The losses of the outsiders are equal to the gains of the insiders, and the market as a whole is a standoff". In his view, crashes are a necessary mechanism for redistributing wealth: small comfort to those who bought Japanese stocks as the Nikkei Index touched 37,000, or who bought U.K. property during the Lawson boom and today have negative equity.

We read of past dramas and the varying efforts to stem panic, the original (1890) Barings crisis and the Rothschilds' truly remarkable transfer of £400,000 gold (mostly in sovereigns) gathered from their European offices and physically shipped to London, after an 1825 run on the Bank of England. Central banking secrecy has been carefully, minutely probed for details of these and other rescues.

Professor Kindleberger leaves us with the final impression that although these speculative binges will continue, we have at least learned something of the handling of the resultant panics. His rather downbeat conclusion seems to be that central banks can reduce the impact of financial crises, albeit at a price which might only become apparent after the event; throwing money at the problem of an acute liquidity shortage, will inevitably lead to increased inflation. The alternative of allowing major banking failures, perhaps followed by prolonged economic depression as the bubble deflates, is anathema; perhaps inflation is the price of democracy.

A. B. P.

LOAN TRUSTS FOR SMALL AND MEDIUM SIZED ENTERPRISES IN THE UK

By Stephen Kershaw, published by Bow Group Research, March 1996, Price £5.00

No one need doubt the importance of small and medium sized enterprises (SMEs) in providing employment and growth in the British economy – and indeed in almost any economy in the world today. Any move therefore which can assist their ability to prosper is to be welcomed – and special note should be taken of schemes designed to help them in countries competing with us.

SMEs in Britain rely heavily on bank overdraft facilities – now just as they have done for a very long time. But overdrafts used to be a relatively inexpensive form of finance – it was reasonable in (say) the decade after 1945 for growing companies to turn to their banks for large overdrafts to finance working capital of all kinds.

But times have changed. Banks have found new opportunities for lending to unusual ventures, for speculative purposes, for home loans and for simple consumer purchasing. These are all more risky, they often involve bad debts – mortgage defaults, bankruptcies, small sums too costly to chase to say nothing of massive losses to such things as the Channel Tunnel, Canary Wharf and loans to Third World governments.

To cover all these risks, interest charged by banks – on loans and overdrafts has had to rise and the steady reliable SME sector has had to pay up alongside more variable sectors.

Thus it is most timely for Kershaw to point out that it is high time special provision was made for the SME sector – as is the case in Germany. His suggestions make eminent good sense and would enable to SMEs to obtain loans from banks at lower interest rates – rates that would lower costs and enable them to compete effectively.

First, the government – or the banks – should set up bank institutions specialising in loans to SMEs. This specialisation would enable these institutions to concentrate on lending to SMEs thus avoiding the premiums currently needed to finance other forms of lending. Secondly, the government should extend its small business loan guarantee scheme to these loans, thus enabling rates to be lowered further. Obviously very careful and skilled vetting of those SMEs to qualify would be required – but this is precisely what truly skilled bank management ought to be all about! Thirdly the loans should have rather constant interest rates over fairly long periods to enable SME financial planning and to enable the lending institutions to recoup funds during low interest rate periods that are forfeited during high interest rate periods. SMEs would accept this in periods of "low" interest rates because funds would still be more costly if borrowed elsewhere.

The author chooses to call these institutions "Loan Trusts" but the name, whilst sensible, is irrelevant to the principle – that good banking should match risk and reward and should not force one aspect of the economy to subsidize another. That is why, despite the call for government action, this paper is in fact a call for better and more competitive banking and deserves serious consideration.

J. B.

NATURAL CREATION OR NATURAL SELECTION?

*By John Davidson. Element Press 1992 Price £9.99**

Here are two ridiculous theories. But unless (or until) a third is suggested, one of them must be true …

The first is that in some realm beyond our present comprehension there exists some creative force which through a "formative mind" has conjured many many *minds* – a feline "cat" sort, a "dog" sort, a "spider" sort, a "human" sort an "ape" sort – right down to a "tree" and a "grass" sort and these in turn have found physical expression via the innovation of genes into the physical beings we can see and know. Each of these forms part of an interdependent whole – predators maintain the balance of numbers for example and plants provide oxygen, whilst animals produce carbon dioxide on which the plants depend. Each of these beings can adapt and change to survive in changing environments – but nonetheless retain their pre-existing mind nature. Dogs have not become cats, cows have not become horses, apes have not become humans, seaweeds have not become lilac trees. Through vast time spans there are periods of generation, degeneration and regeneration. But mind came before matter.

The second is that "once upon a time" the earth's surface, unaided by an atmospheric screen of life-produced gases, miraculously cooled, that without life oxygen was produced, thus creating, with hydrogen, water which then mixed with

* Available from the distributor on (01954) 781074.

igneous rock fragments to form a lovely mud in which tiny bits just happened to combine in such a way as to be "alive" and reproduce. Unhappily no scientist has ever been able to reproduce this event but anyway, on the assumption that it occurred, these "beings" just by chance somehow got bigger and more complex and then diversified and through a very wasteful process in which most died out but the most "successful" survived, a myriad different living *bodies* came into existence, which then developed complex gene patterns including consciousness and the mind. We can now study these gene patterns and can indeed record and interpret perhaps 1% of a set of genes – though that only in terms of physical characteristics. Chains of genes moreover are like tubes and 99% of the volume of a set of genes appears to be empty space containing maybe nothing at all or maybe something beyond our comprehension. But chance has been the agent of change and fitness-to-breed the determinant of survival. The hunt, by no means successful, is on for "missing links" in evolution which can prove this train of events. But matter came before mind.

Each of the "fantastic" theories sketched above can be shown to be absurd, unrealistic, wishful thinking, unsupported by sufficient evidence. Each, in short, is a *faith*, the first born of the observations of the biologist and mystic, the second born of the determination to force rationality into service to overcome the fear of the unknown. Each creates aims and values gods – if you prefer eloquent language. The first would have each of us play our parts to the very best of our abilities whilst the second would point out that reproduction and survival is all that matters in the end. It would seem that a choice has to be made though it is interesting to note that Charles Darwin was not at all as committed to the second as his disciples would have us understand.

And so we are free to choose our "faith" – in spite of the fact that the second theory is taught as truth in today's schools. Davidson has shown in this well argued and scientifically described work that there is good reason both to doubt evolutionary theories and accept the alternative. This is a book to enrich and intrigue us all. It is fun to read and fascinating to contemplate and it claims logically that, far from being a recent arrival, man has always been here. This book is seriously and sincerely "recommended reading"

J. B.

LETTERS

The Money Concept Conundrum

Two novel and well considered responses to "The Lessons for Britain from the Success of German Counter-Inflation Policy" by Dr Walter Eltis and the "Notes on Dr Walter Eltis' Talk" by Geoffrey Gardner from Mr John Tomlinson and from Mr T. B. Haran

Sir,

Herbert Giersch's view that 'inflation depended upon the growth of the money supply' is a view I wholeheartedly support and Dr. Walter Eltis was right to remind us of Giersch's view and of the role that his understandings have played in maintaining the strength of the D Mark. We must keep that strength in perspective, however. When we say that the D Mark is a strong currency, what we are really saying is that it is not being debased as fast as other currencies. Eltis does not take up this point.

Later in his paper Eltis notes that Britain and Germany have had average inflation rates of 8 and 3 per cent over the past twenty years. What he does not say is that at an inflation rate of 3 per cent per annum a currency will diminish in value by 50 per cent in 24 years. So, while it is perfectly correct to refer to the D Mark as being stronger than the Pound or the US Dollar, I find it difficult to describe any currency that loses half its value every 24 years as 'strong'.

Nevertheless, the rate of debasement of the D Mark is certainly less than that of most other currencies. Germany must have been doing something right. Eltis gives all credit to the separation of the D Mark from the Dollar in 1968. Yet he fails to demonstrate how that separation did or even could impede the growth in the German money supply. To gain a better understanding of the process and to test the veracity of his arguments, I suggest that we begin with a clear understanding of what the money supply is and how it grows.

My understanding of the first is: the total money supply is the sum of deposits (there are many arguments concerning precisely which deposits should be included – but, certainly all arguments will include commercial bank deposits) plus notes and coins outside the banking system (i.e. in someone's pocket or cash register, under a mattress, etc.).

With respect to the second, the money supply certainly grows when governments or central banks mint new notes and coins in excess of those required to replace those withdrawn from the market.

The banking system also creates new money. Commercial banks no longer issue their own notes and coins. Today, bank created money comes into existence through the creation of new deposits. Banks create new deposits by lending depositors' funds which are then used in exchanges and re-deposited into the system. When a bank makes a loan, its obligations to its depositors do not change. No deposits are reduced.

When the borrowed money is put into an account, new deposits are created which are in addition to those which existed at the time the loan was made and for which the bank remains obligated. Sometimes, these new deposits are created in the lending bank itself and at other times they are created in another bank.

In the UK, for instance, where bank lending often means the granting of overdraft facilities, the borrower will simply issue a cheque on his account and the recipient of the cheque will deposit it into his account at his own bank – which may or may not be the same bank as that upon which the cheque was drawn. Throughout the entire process, from the arranging and agreeing of the overdraft facility, through the first meeting with the bank's lending officer, to the point at which the facility is put in place and the borrower is issued with a cheque book and on to the point where the borrower issues his cheque, there will be no increase in deposits.

It is only when the recipient deposits the cheque into his account that new deposits are created. When the cheque is cleared the borrower's overdraft or loan account will increase. There will be no reduction in deposits as a result of this series of actions. Therefore, this series of actions will produce net new deposits within the banking system as a whole. The total of all deposits will have increased. New money will have been created.

Where the recipient of the cheque deposits it into a different bank than that of the issuer and the new deposit occurs at a bank other than that which granted the loan, both banks can genuinely argue that they have not created new money. The lending bank can argue that it merely loaned depositors' money – money which already existed. The receiving bank can argue that it merely received money from the bank upon which the cheque was drawn – money which already existed. Both arguments have validity.

What cannot be denied, however, is that the combination of the actions within the process as a whole created a new deposit without an offsetting withdrawal and, therefore, net new deposits or new money will have been created.

Similarly, when banks grant new loans which are not overdraft facilities or funds deposited into the borrower's account and, instead, draw their own cheques in favour of the borrower's suppliers, new deposits will not be created until the cheques are deposited into the suppliers' accounts. Once the cheques are deposited into the suppliers' accounts new deposits will have been created and net new deposits or new money will have been created. Both the bank upon which the cheque was drawn and the receiving bank can – and do – use the same arguments as above to avoid being seen to be responsible.

Often banks make loans and deposit the full amount of the loan into the borrower's account at their own bank. No other deposit at the lending bank will be reduced by the bank making the loan. Therefore, the new deposit will increase the total deposits at that bank. Where the lending and receiving banks are one and the same, the argument that that particular bank created net new deposits or new money is more difficult to avoid. Nevertheless, the bank can still argue that it is merely transferring money that already exists from one account to another.

Clearly, it is the process itself – the combination of the lending of depositors' funds and the resultant re-depositing into the banking system of those same funds – that produces net new deposits and, therefore, new money.

The question then arises: is this process a major or a minor contributor to the growth in the money supply? The data since 1971 is quite clear. Using M4 as the measure of money stock. We find:

	1971	1995	Created in the 22 year period
Deposits	£27.5 bn	£587 bn	£559.5 bn
Notes and coins	£3.5 bn	£21 bn	£17.5 bn
Total	£31.0 bn	£608 bn	£577.0 bn

Over the 24 year period the British government minted new notes and coins to the extent of £17.5 billion while the banking system created new deposits to the extent of £559.5 billion.

The extent to which government created money contributes to inflation is actually very limited indeed. Bank lending is the principal destroyer of savings.

The total of all deposits in 1971 amounted to little more than 5% of the total by 1995. This represents the largest redistribution of wealth this century – a redistribution from depositors to borrowers and those with whom borrowers treat.

If the government had itself printed the £559. 5 billion that the banks produced, it could have paid off the entire £300 billion national debt. It would not have had to pay £30 billion in interest last year, nor would it have had to have paid interest during the intervening 24 years. With the £259 billions left over after having repaid the national debt and the savings in interest, we could now have the finest infrastructure, the finest public transportation system and the finest national health facilities that can be obtained – all of which would have been fully paid – and we could have had all of it without having experienced any more inflation than we have already suffered.

It is argued by Eltis and others that the cure for inflation is to control the rate of growth of the money supply by the manipulation of interest rates. This is a much misunderstood approach. Consider, for instance, the current situation. Western economies need to create new jobs to reduce the levels of unemployment. Thus, it is argued, interest rates must be reduced. People will then borrow money both to spend and to invest. Economic activity will increase and the economy will be healthier. While this may be perfectly true, from another perspective we can see how total reliance on debt has turned common sense on its head. Surely it is a nonsense to suggest that, in order for the economy to improve, either more people must get into debt or those who are already in debt must get deeper into debt. Yet that is precisely what presumably intelligent people – including the Chancellor's 'wise' economists – now tell us.

When this advice is followed, a process is triggered which has unfortunate and unacceptable side-effects. The increased level of bank lending (which follows from the reduction in interest rates) will then increase the money supply and, thus, increase the pressure for inflation. As the pressure for inflation increases, interest rates will then have to be raised to reduce the level of borrowing which, in turn, will reduce the rate of increase of the money supply and, thereby reduce the pressure for inflation. But, unavoidable cost increases will have been imposed on all borrowers – including those who have just been enticed into borrowing by the previously reduced interest rates.

Borrowers will then be caught in a squeeze. To pay the higher interest charges, both they and their customers will have to make reductions in other areas of their expenditure. As customers buy less, sales will decline yet costs will have increased. Costs will then need to be trimmed. The net result will be a reduction in the rate of economic activity, higher levels of unemployment and higher levels of individual and business bankruptcy.

Dr. Eltis speaks of the great political sacrifices made by John Major and his Chancellors. He has missed the mark. The sacrifices have been made by those who have lost their jobs, their homes, their businesses and, as a result, far too often, their families. John Major *et al* still have their parliamentary incomes, expense accounts and chauffeur-driven cars.

The banks, on the other hand, whose lending actually produces the inflation, when interest rates are increased find themselves with increased income and increased profit margins. This can only be an incentive to lend more. Certainly, I found my letter box filled with enticements to borrow throughout the entire period of very high interest rates. If nothing more, this must be an indication that increasing interest rates to reduce lending may well be counter-productive. The use of interest rates as a tool of economic management needs urgent re-examination. Nor must we overlook the reality that, while we all wish businesses to be successful, the more successful the banks are, the greater the burden of debt that has to be carried by the economy and by future generations. The entire banking and monetary system needs serious rethinking.

Consider an alternative. If, instead of lending depositors' money, banks encouraged and assisted depositors to make equity investments with their money, the situation would be very different indeed. Rather than continuing to burden the economy and future generations with debt, when loans were repaid banks would not use the money repaid to make new loans to replace the repaid ones. The money would be used to make new equity investments for the depositors to whom it belonged and the process of reducing the burden of debt would begin – freeing and unleashing the economy. The process of building a collection of assets to leave to future generations would also begin. Both could contribute to a healthier economy and a sounder future for all. Surely that is a direction which ought to be pursued with vigour.

The question remains: why didn't the banking system create money in Germany on the same scale that it did in the UK? I suggest the answer is more closely related to the practices of German banks. They make both long-term loans and equity investments. To the extent that they make long-term loans, they remove the need for repayments and refinancing in the short-term. Therefore, they reduce the rate at which loans are made and, thus, the rate at which they create net new deposits.

To the extent that they make equity investments, they finance business and industry without burdening them with debt, without burdening their economy with debt and without burdening future generations with debt. The combination of long-term debt and equity has provided more than adequate finance for German industry over the past twenty five years without producing the level of inflation created by the short-term lending practices of UK banks.

It is this very emphasis on long-term finance for business and industry that has allowed German management to focus on production. Long-term loans don't require German industries to withdraw money to make repayments during the short to medium term – freeing them to plan better. Equity finance is the longest term finance. It requires neither repayment nor interest payments. Instead, investors expect dividend payments and, unlike interest payments which must be paid whether or not there are profits, dividend payments are made only if there are profits. So, with German banks concentrating on equity finance and long-term loans, the level of inflation has been kept low and, as a result, it has also been able to keep interest rates low. German industry has had the competitive advantage of considerably lower capital costs. Without the worry of having to maintain high gearing or of having to service and replace short-term debt finance, German executives have been able to maintain a clear focus on production. These advantages were specific to the German economy.

No two governments or economies behave exactly the same. The rate of demand for and creation of new debt will be different in each different country. It follows that the banks in each country will expand money supply at different rates. In order to control inflation, the European Community is seeking to establish a new central bank and a new single currency.

John Tomlinson
The Old Vicarage
Steeple Barton
Oxon
OX6 3QP

Sir

Perhaps I may be allowed to make some comments on the main issues raised.

Inflation and deflation were in existence before money was introduced. They cannot, therefore, be monetary problems. For example, in a primitive society, A performs a service for B on the understanding that the latter will reciprocate later by doing 10 hours' work for the former. In the event, B was able to insist on working for only 8 hours in settlement. His debt became less burdensome; inflation arose.

Alternatively, suppose that A gained the upper hand and obtained 12.5 hours' work. His credit became more valuable; deflation ensued.

It follows that inflation is not a monetary phenomenon. What then is it?

People trade in services. Each party (individual or group) has either contributed more in services than obtained (service creditors) or the reverse is true (service debtors). Because there are parties on each side of every transaction, total service credits always equal total service debts. A became a service creditor, B, a service debtor.

Services have to be valued in a unit of account to make them generally, and not just directly, exchangeable. That, however, does not alter their nature nor does it cause their properties to be transferred to the measure. In any event, a factor consisting of two separate sides cannot adequately be represented by a single one. Accordingly, it could be said that there are two types of money, (1) basic money (credits and debts in services) and (2) nominal money (media of exchange and bank deposits).

Reverting to the example, suppose that nominal money had already been introduced, that A received £10 for his service, that, in the first case, B had to be paid £1.25 per hour and that, in the second, he got 80p per hour.

The rates of inflation can now be measured in terms of cash, but they could already be calculated in terms of hours. It is, therefore, the alterations in the trading conditions which create inflation, while the fall in the value of the pound is a reflection. Inflation can, accordingly, be defined as a varying bias in the terms of trade favouring service debtors and, similarly, deflation is such a bias favouring service creditors.

Basic money is comprised, on the one hand, of the credits in services and, on the other, of the debts in services. Its quantity is subject to creation and destruction in accordance with 'the status rules'.

In brief, these are:-

- Debtor spending on creditor services – an increase (B's on A's).
- Creditor spending on debtor services – a reduction (A's on B's).
- Debtor spending on debtor services – no change (B's on another B's).
- Creditor spending on creditor services – no change (A's on another A's).

Every transaction alters the constituent parts of the basic money supply. The credits can be negotiated and the debts taken over. Nevertheless, total credits always equal total debts. Moreover, that has been the situation since primitive man started trading with his neighbour!

Cash circulates, but, as seen from the experiences of A and B, its passing has different results, first confirming the creation of basic money and then its destruction. It keeps changing character, backwards and forwards, sometimes representing purchasing power and, for the rest, being evidence of offset against debts, according to whether it is respectively in the hands of a service creditor or service debtor. Its use is controlled by the trading activity, while its functions are to act as a medium for the exchange of services and a unit of account. Basic money is the store of value. There are no material differences in payment by cash, by cheque or by any other means of settlement. Basic money is the real kind and its quantity the real money supply. It cannot be measured, but, as can readily be seen, it is selfregulating. Attempts to measure 'the money supply' with monetary aggregates, such as cash and deposits, produce meaningless figures. The results can best be described as 'false money supply'.

The main suppliers of goods and services are bank borrowers. They incur two debts, one to a bank in terms of cash and the other, on spending, to the community in terms of services. In turn, they have to perform reciprocal services to obtain the funds to repay their loans. Thus it is trade which affects the economy, while the loans merely facilitate the procedure.

Dr Eltis mentions Herbert Giersch's belief that 'inflation depended on the growth of the money supply'. The reference is, of course, to false money supply and is inevitably unsound. In fact, basic money supply can grow for two reasons, (1) because of additional trading activity and (2) because it is being represented by more and more units of less and less value. The first process is healthy, while the second is undesirable and a reflection of the faults in the trading system.

Dr Eltis maintains that there "is no way inflation can be brought down without reductions in demand and spending". There are several ways.

Increases in inflation are caused by additional pay costs, which the service debtors recoup from raised prices. Inflation, however, has a weakness; it has to be financed. The banks could agree to lend funds for increased business activity, but not for extra pay. Alternatively, the Bank of England, as the regulatory authority, could issue instructions to that effect. As for the government, it could enact (1) that organisations making losses must cut pay and (2) that those increasing pay from profits must *reduce* prices by an equivalent amount. It also has the ultimate sanction, which is to reduce pay and prices compulsorily.

All these practicable remedies confirm that inflation is a trading problem and not a monetary one.

Dr Eltis states, "The British situation has been very different since 1989 when high interest rates were imposed, which brought inflation down rapidly from 9.5 per cent in 1990 to an underlying rate of little more than 2.5 per cent in 1995". My analysis of this situation is very different. Losses, mainly in property, insurance and banking, destroyed part of the basic money supply – an equal amount of credits and debts. There was then insufficient purchasing power in the economy to buy the available goods and services; high interest rates made the position worse and recession resulted. The scales were tipped, but not entirely, in favour of the service creditors and inflation naturally fell as fear of unemployment reduced pay claims. A further contributory factor was the loss incurred by the Treasury in its ill-fated attempt to prevent the pound from falling through its lower limit in the exchange rate mechanism.

Redundancies, reorganisations, take-overs and discounts have given the illusion that a recovery is taking place. Industry, however, has followed these last-ditch activities by transferring some production abroad, so recovery of consequence is out of reach without remedial action. Industry has only one option left; it must cut pay and prices.

The proper function of the interest rates is to hold the ring between the demand for borrowing and the deposits available for lending. Thus, if they are left to do so, demand management results!

Artificial interest rates are, therefore, undesirable. Particularly reprehensible is the practice of putting them up to defend the exchange rate. Countries trading at a loss should defend their exchange rates by cutting pay and prices.

Mr Gardiner writes in regard to the German banks "… they raised new capital to provide the base for increased lending. In one case, I believe, the sum raised was DM 2.6 billion, enough to allow the creation of at least DM 30 billion of weighted assets".

This, of course, is a version of The Theory of the Pyramid of Credit, which holds that if £100 is deposited with a bank, which is lending on a liquidity rate of *8%* deposits of £1,250 will result. Under the theory, the service debtors only borrow and do not reduce deposits by performing reciprocal services! Put the other way round, the service creditors only deposit and do not spend! Where does the economics profession find all these obliging parties?

The ultimate source of all borrowing, no matter how raised or through which market, is the deposits available for lending. The DM 2.6 billion was, therefore, already on deposit with the German banks and, if Mr Gardiner's views were correct, would already be supporting a pyramid of credit. A new pyramid would then replace an old one and there would still be no effect on the quantity of basic or nominal money. Real (basic) money can only be created by debtor spending on creditor services.

Assume that A is a bank's first customer and deposits £100. It lends £90 to B. It is obvious that B now holds 90% of A's funds. If then the book-keeping system were designed to represent the facts, the advance would be deducted from the deposit. Banks may raise capital, but they do not use it for lending. Even, however, if they did, the lending would not create money. As it is, they run current accounts in their books, which are normally overdrawn. Yes, the banks, like most commercial organisations, are bank borrowers!

While arguments are going on in regard to the trivial issue of raising and lowering interest rates, our real problems are being ignored. These are, given our world-wide commitments, an inadequate share of global industry, recurring trade deficits, an excessive disparity between boardroom and shopfloor rewards, a too high pay and price structure, unemployment and inflation. In addition a dangerous situation is arising in respect of inward investments. What will happen to these when lower pay and price industrial economies from the East join the European Union?

Charts showing the annual rates of inflation reveal partially the extents to which the service debtors have cheated the service creditors by performing fewer reciprocal services than appropriate. The positions are understated, because every year scientific and technological advances make it easier and cheaper to maintain the standard of living. Thus, these benefits have also been acquired by the service debtors. The economy has underperformed for both reasons.

Pay and price cuts would restore lost purchasing power by causing the basic money supply credits to increase in value, while the service debts would become more burdensome in step. In other words, the remedy would favour the service creditors for a change at the expense of the service debtors.

Demand would rise, more employment would result and the workforces would discover that, since the savings in pay costs would be taken from prices, the remedy would not be painful.

In modern economies, it is necessary to cause a small reduction annually in the price level. That would ensure that the benefits of scientific and technological advances were passed on to all members of the community right down to the poorest. Everyone would find that their standard of living was rising.

All monetary measures are based on unrealistic fears, for example, of inflation or overheating, and are designed to curb the economy. On those grounds alone they should be abandoned. The main objections, however, are that they are based on false conceptions and do not deal with our real problems. In truth, demand is healthy and, as far as possible, should be accommodated. In these circumstances, the government should take practical control of the economy and stop relying on unsound monetary theory.

In this regard, my own book, 'The Monetary Analysis', is still, as far as I can discover, the only one on the right lines. *Inter alia*, it proves that inflation is not a monetary phenomenon, that money cannot be created by bank lending and that the cure for all our economic problems is for the government compulsorily to cut pay – not at the bottom, but progressively thereafter – and to insist on the savings in costs being deducted from prices.

We simply must put the economy on a more competitive footing.

T. B. Haran
Grianan
23 Orchard Road
Bromley, Kent
BRl 2PR

The Chairman submitted this story for publication.
It is so unusual that he felt everyone would enjoy reading it!

1994's MOST BIZARRE SUICIDE, Recounted by Mark V. Flinn of the Department of Anthropology at the University of Missouri, USA.

At the 1994 annual awards dinner given by the American Association for Forensic Science, AAFS President Don Harper Mills astounded his audience in San Diego with the legal complications of a bizarre death. Here is the story.

"On 23 March 1994, the medical examiner viewed the body of Ronald Opus and concluded that he died from a shotgun wound of the head. The decedent had jumped from the top of a ten-storey building intending to commit suicide (he left a note indicating his despondency). As he fell past the ninth floor, his life was interrupted by a shotgun blast through a window, which killed him instantly. Neither the shooter nor the decedent was aware that a safety net had been erected at the eighth floor level to protect some window washers and that Opus would not have been able to complete his suicide anyway because of this.

"Ordinarily," Dr. Mills continued, "a person who sets out to commit suicide ultimately succeeds, even though the mechanism might not be what he intended. That Opus was shot on the way to certain death nine stories below probably would not have changed his mode of death from suicide to homicide. But the fact that his suicidal intent would not have been successful caused the medical examiner to feel that he had homicide on his hands. The room on the ninth floor whence the shotgun blast emanated was occupied by an elderly man and his wife. They were arguing and he was threatening her with the shotgun. He was so upset that, when he pulled the trigger, he completely missed his wife and the pellets went through a window striking Opus.

"When one intends to kill subject A but kills subject B in the attempt, one is guilty of the murder of subject B. When confronted with this charge, the old man and his wife were both adamant that neither knew that the shotgun was loaded. The old man said it was his long-standing habit to threaten his wife with the unloaded shotgun. He had no intention to murder her – therefore, the killing of Opus appeared to be an accident. That is, the gun had been accidentally loaded.

"The continuing investigation turned up a witness who saw the old couple's son loading the shotgun approximately six weeks prior to the fatal incident. It transpired that the old lady had cut off her son's financial support and the son, knowing the propensity of his father to use the shotgun threateningly, loaded the gun with the expectation that his father would shoot his mother. The case now becomes one of murder on the part of the son for the death of Ronald Opus.

"There was an exquisite twist. Further investigation revealed that the son [Ronald Opus] had become increasingly despondent over the failure of his attempt to engineer his mother's murder. This led him to jump off the ten-storey building on March 23, only to be killed by a shotgun blast through a ninth storey window.

"The medical examiner closed the case as a suicide."

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

BENEFITS

Members are entitled to attend, with guests, normally 6 to 8 talks and discussions a year in London, at no additional cost, with the option of dining beforehand (for which a charge is made). Members receive the journal 'Britain and Overseas' and Occasional Papers. Members may submit papers for consideration with a view to issue as Occasional Papers. The Council runs study-lectures and publishes pamphlets, for both of which a small charge is made. From time to time the Council carries out research projects.

SUBSCRIPTION RATES

Individual members	£25 per year
Corporate members	£55 per year (for which they may send up to six nominees to meetings, and receive six copies of publications).
Associate members	£15 per year (Associate members do not receive Occasional Papers or the journal 'Britain and Overseas').
Student members	£10 per year
Educational Institutions	£40 per year (for which they may send up to six nominees to meetings and receive six copies of publications).

APPLICATION

Prospective members should send application forms, supported by the proposing member or members to the Honorary Secretary. Applications are considered at each meeting of the Executive Committee.

APPLICATION FORM

To the Honorary Secretary Date ....
Economic Research Council
239 Shaftesbury Avenue
LONDON WC2H 8PJ.

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

This application is for	Individual membership (£25 per year)
(delete those non-applicable)	Corporate membership (£55 per year)
	Associate membership (£15 per year)
	Student membership (£10 per year)
	Educational Institutions (£40 per year)

NAME ....
(*If Corporate membership, give name of individual to whom correspondence should be addressed*)

NAME OF ORGANISATION ....
(*if corporate*)

ADDRESS ....

....

....

PROFESSION OR BUSINESS ....

REMITTANCE HEREWITH ....

SIGNATURE OF APPLICANT ....

NAME OF PROPOSER (*in block letters*) ....

AND SIGNATURE OF PROPOSER ....